CRÉDIT AGRICOLE S.A.

14 January 2020

GERMANY

2020-2021 SCENARIO

Philippe VILAS-BOAS

"A slow trudge out of recession for the manufacturing sector"

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SCENARIO 2020-2021

1 OVERVIEW

A SLOW TRUDGE OUT OF RECESSION FOR THE MANUFACTURING SECTOR

Up to now, the German economy has proved resilient despite the prolonged decline in industrial output. The robust expansion of the service sector saved the country from economic recession in Q3. That said, GDP growth is once again expected to be excessively moderate in Q4 and the prospects of a recovery for the manufacturing sector out of reach. The slump in industrial output has now lessened and the latest surveys point to a slow and gradual recovery for the sector. Domestic demand has continued to drive growth, on the back of a sharp rise in private-sector consumption and persistently robust investment. The rise in wages and payroll jobs are headed for a decline, setting the stage for a contraction in disposable income. However, weak inflation should continue stimulating household purchasing power. Moving forward with an expansionist fiscal policy will also help bring the German economy in for a softer landing. Investment is likely to slow even further due to lower profit margins in industry tied to weak activity. Net exports, on the other hand, may contribute more to GDP growth, as suggested by the timid pick-up in manufacturing export orders. Our scenario forecasts modest full-year growth of 0.6% in 2019 and slight growth acceleration to 0.8% in 2020, buoyed by a more optimistic export outlook.

Household consumption is set to remain the main pillar of growth. It is expected to improve in Q4 at roughly the same pace as it did in Q3. In 2020, wage increases will be less generous due to below potential economic activity, weighing on branch negotiations. The slowdown in payroll jobs will also put the brakes on consumption. The decline in temporary jobs and use of partial unemployment in industry will slow growth of disposable income. On the plus side, purchasing power will get a boost from low inflation.

Fiscal policy will remain on an expansionist track (0.7 GDP pt in 2019). The budget for 2020 is shaping up to be less ambitious, but nevertheless still expansionist (0.3 GDP pt). The two-person team heading up the Social Democratic Party may seek to negotiate additional expenditures. However, they have little room to manoeuvre without something to offer the Conservatives in return, who refuse to budge on the principle of balancing the budget without leverage.

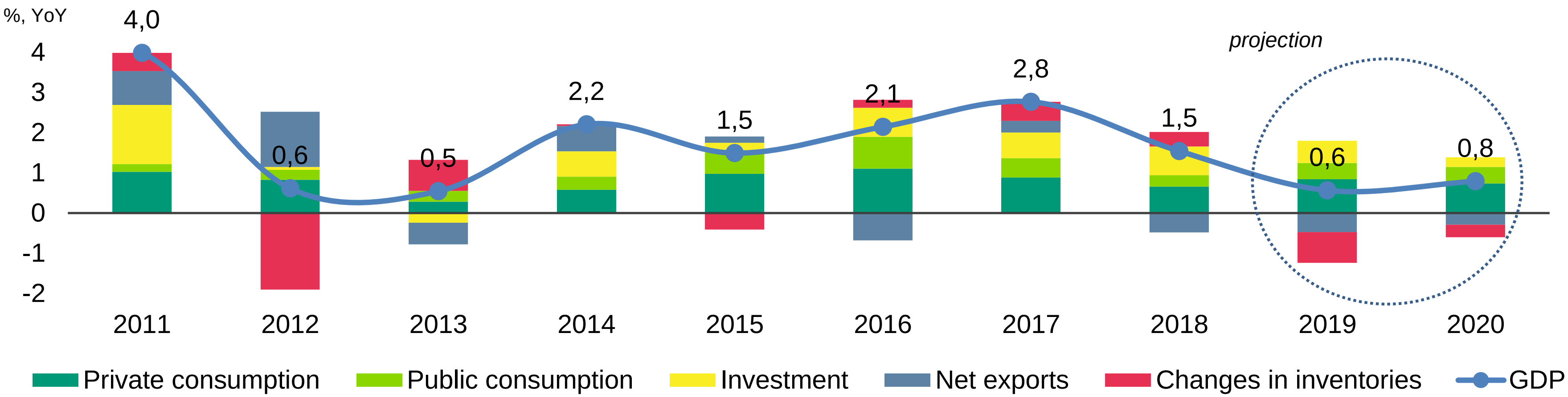
Overall investment is poised to lose steam due to two cumulative effects. First, with economic activity flagging, corporate margins are under major pressure, particularly in industry, automatically leading to a drop in business investment. Second, investment in construction is liable to drop off after four years of intense development. Housing demand is on the decline, in step with decelerating payroll jobs and lower immigration. Real estate prices are back on a more sustainable track and production of real estate assets is gradually catching up with demand.

Net exports should prove less of a drag on growth as overall economic activity begins to recover. Demand for German products may have the potential to accelerate back to a rate more on par with recent years. Exports to the United States are still going strong despite underlying threats, and exports to the UK are also more dynamic.

1 OVERVIEW

A SLOW TRUDGE OUT OF RECESSION FOR THE MANUFACTURING SECTOR

Contributions to annual growth



Sources: Eurostat, Crédit Agricole S.A

Germany	Yearly average (YoY, %) 2018	2019	2020	2021	Quaterly growth (QoQ, %) 2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4
GDP	**1,5**	**0,6**	**0,8**	**1,1**	**0,5**	**-0,2**	**0,1**	**0,1**	**0,3**	**0,3**	**0,3**	**0,3**	**0,3**	**0,3**	**0,3**	**0,3**
private consumption	1,2	1,6	1,4	1,3	0,8	0,1	0,4	0,4	0,4	0,4	0,4	0,4	0,3	0,3	0,3	0,3
investment	3,5	2,7	1,1	1,3	1,6	-0,3	-0,1	0,0	0,5	0,5	0,5	0,5	0,2	0,2	0,2	0,2
change in inventories*	0,4	-0,8	-0,3	0,0	-0,9	0,3	-0,8	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
net exports*	-0,5	-0,5	-0,3	-0,2	0,5	-0,6	0,5	-0,1	-0,1	-0,1	-0,1	-0,1	0,0	0,0	0,0	0,0
unemployment rate	3,4	3,2	3,4	3,5	3,2	3,1	3,2	3,2	3,4	3,4	3,4	3,4	3,5	3,5	3,5	3,5
Inflation	1,9	1,3	1,3	1,5	1,6	1,7	1,0	1,1	1,5	1,1	1,3	1,4	1,5	1,5	1,5	1,5
Government net lending	1,9	1,0	0,8	0,5												

** Contributions to GDP growth*

Sources : Crédit Agricole SA, estimates

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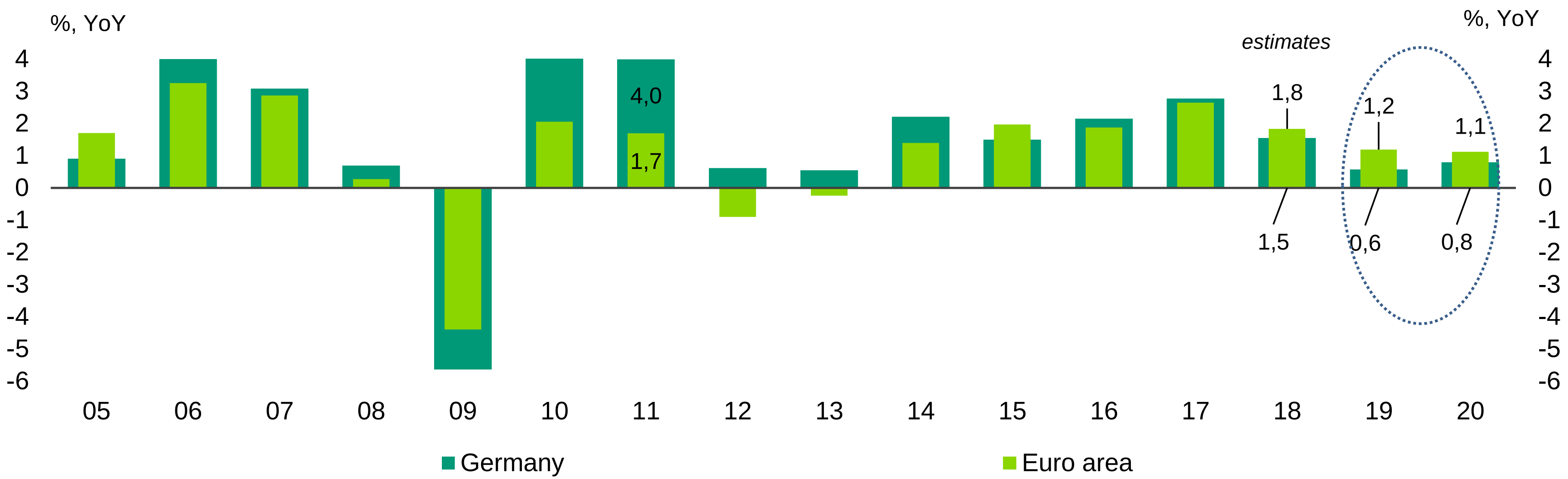
2 RECENT ECONOMIC TRENDS
PENDING A SURGE IN INDUSTRY

The industrial sector is slow to emerge from its lethargy



Sources: Eurostat, Crédit Agricole SA / ECO

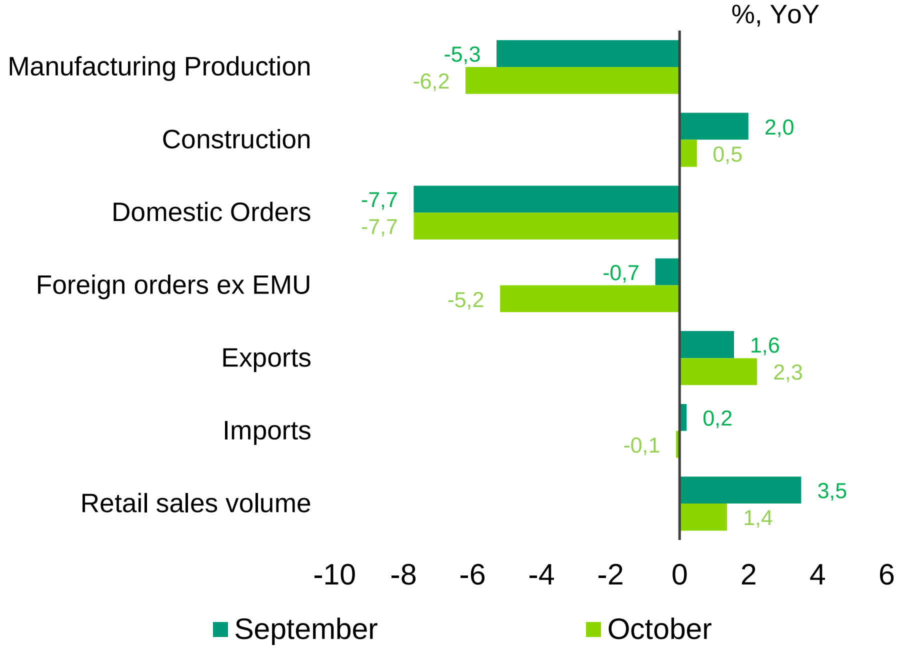
The virtual across-the-board decline in euro zone industry over the third quarter took its toll on growth, although services helped soften the blow to economic activity. We forecast an overall euro zone growth rate of 1.2% in 2019 and 1.1% in 2020. This downturn can be attributed to two opposing impacts on growth. First, the manufacturing slump is now less substantial than it was and is stabilising, offering some respite to the most industrialised countries in the region such as Germany and Italy. Second, the service sectors are struggling to stimulate growth any more, and signs of a slowdown emerged in all countries as Q4 progressed.

Threats of additional US tariffs on European goods may be temporarily set aside as the US presidential race gets under way. The clarification of the UK's decision to leave the EU should be followed by detailed information on the exact conditions of Brexit, as yet to be determined. The German manufacturing sector appears to have hit its rock bottom point, and the economy is still holding up, aided by strong domestic demand. We expect Germany to post weak GDP growth of 0.6% in 2019, improving slightly to 0.8% in 2020, i.e. below its estimated potential of 1.2%.

2 RECENT ECONOMIC TRENDS

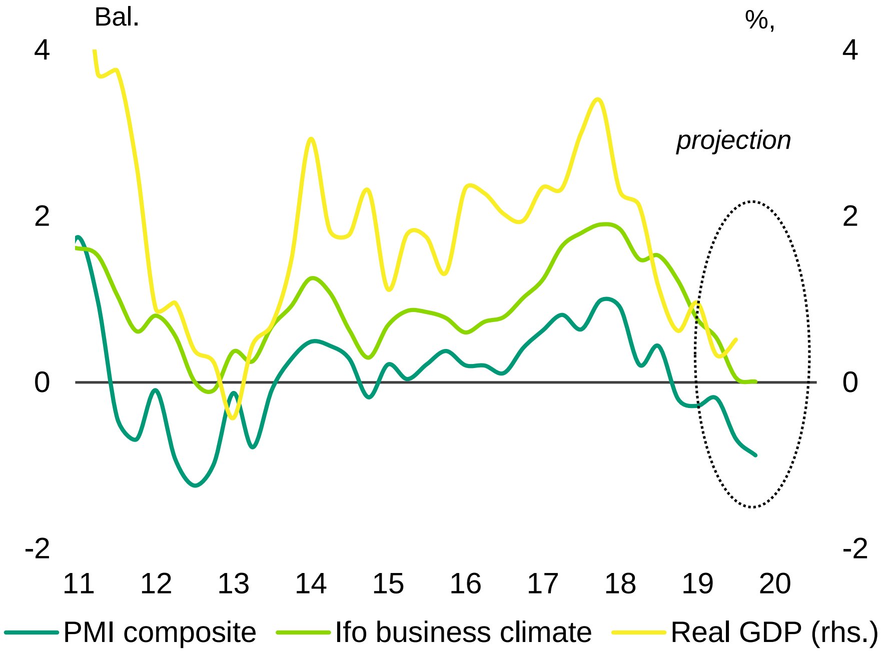
INDUSTRY FAILING TO MAKE A COMEBACK WITHOUT ROBUST DEMAND

Trends of the main signals



Sources: FSO, DB, Crédit Agricole SA / ECO

Business surveys and real growth



Sources: IFO, Crédit Agricole SA / ECO

Hard economic data in the fourth quarter failed to indicate a noteworthy improvement in the manufacturing sector. Industrial output continued to fall, as did total orders. Nevertheless, pharmaceutical orders made a comeback and the decline in automotive sector orders slowed compared to Q3. Foreign trade picked up again, with exports on the more dynamic side and imports on the decline. The construction and retail sectors continued to bolster growth despite the loss of momentum.

Survey data provided a diverging picture of economic activity. The composite Purchasing Manufacturers Index (PMI) slid further in Q4, despite the lesser contraction in the manufacturing sector. Service sector activities are no longer growing enough to offset the manufacturing downturn. However, the IFO business climate index stabilised and six-month forecasts for both the manufacturing and service sectors suggest that the German economy is now on the long slow road to recovery.

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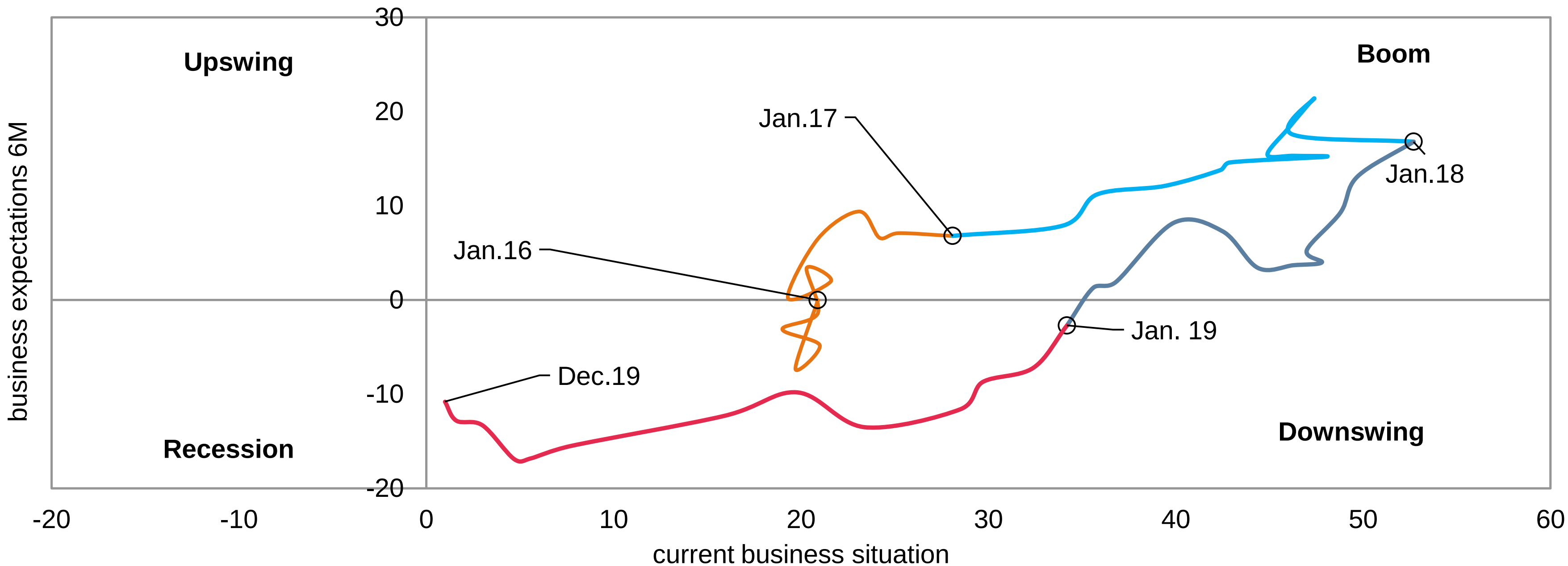
RECENT ECONOMIC TRENDS
LESSER DECLINE IN INDUSTRY OFFERS HOPE FOR A REBOUND

Trend in the industrial cycle (*IFO index*)



Sources: IFO, Crédit Agricole SA / ECO

The business climate index took a major hit in Q3, but bounced back significantly in Q4. A sector-by-sector breakdown attests to an improvement in economic conditions for services and waning pessimism for manufacturing. Trade activities turned out slightly less satisfactory, while construction sector players remained optimistic. Business expressed less uncertainty over future business, pointing to an improving outlook. Leading cycle indicators suggested that the expansion phase would continue in Q4, with an over 80% probability in the month of December versus 30% in October and barely 16% in the summer. Manufacturing orders were weak overall, but did not drop below 2016 levels. The decline in automotive sector orders stabilised and pharmaceutical orders began climbing again. With the manufacturing sector downturn ending up less pronounced this time around, there is some hope that overall activity will improve in the coming months. Our full-year growth forecast now stands at 0.6% for 2019.

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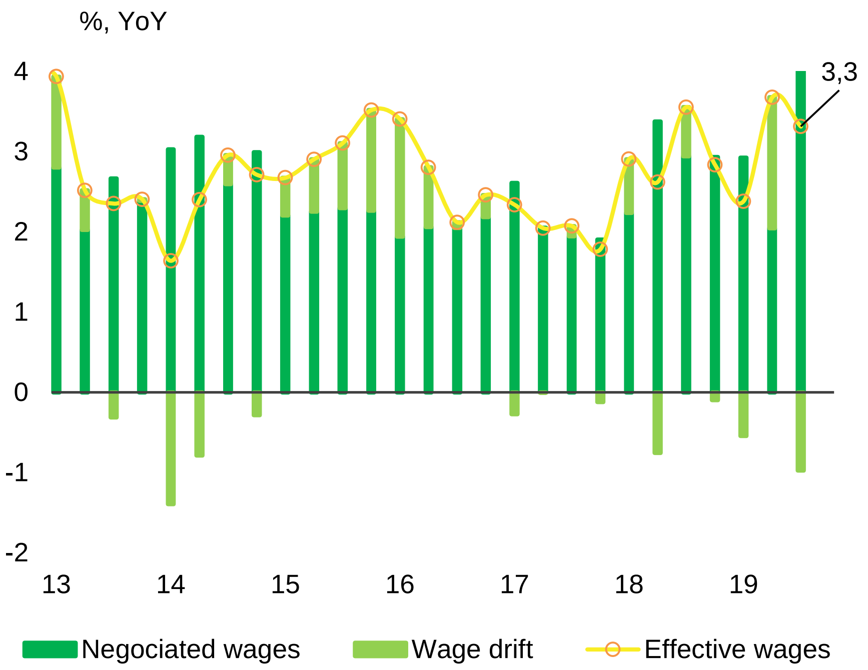
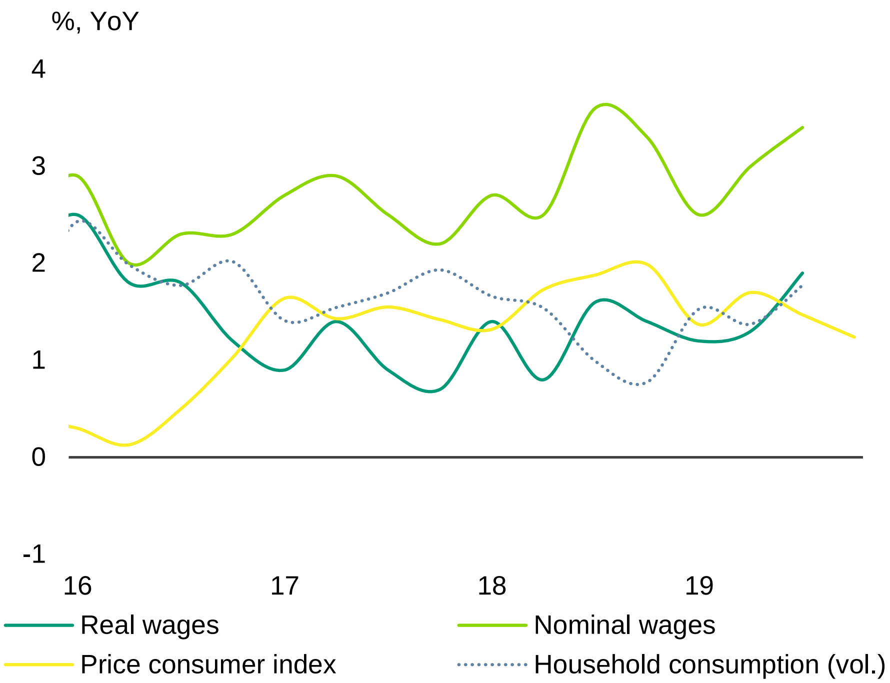
3 BASIS OF OUR SCENARIO
HOUSEHOLD CONSUMPTION AND WAGES

Wage trend



Sources: FSO, Crédit Agricole SA / ECO

Wages, inflation and consumption

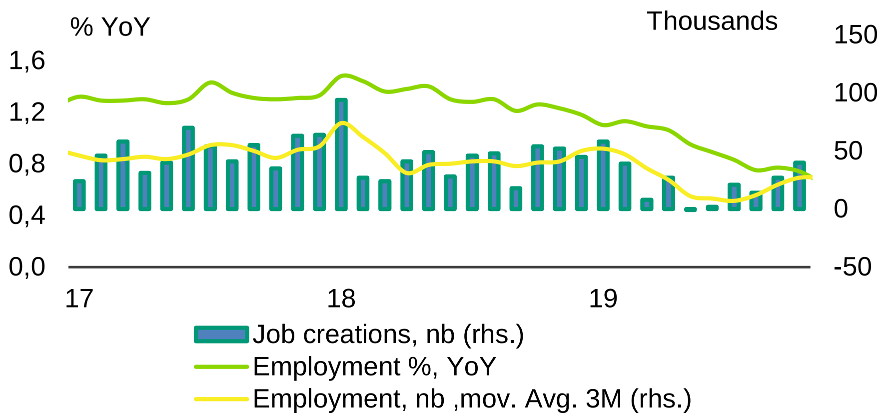


Sources: FSO, Crédit Agricole SA / ECO

Negotiated wages recorded average annual growth of around 2.9% in 2018 and 2019, according to German institute Hans Böckler-Stiftung, a performance that lent itself to robust growth in overall wages and consumption. However, upcoming branch negotiations in the metal working an electrical engineering industry (March 2020) could prove tricky, due to the downturn in industrial activity promising to weigh negatively in the balance. Against this backdrop, growth in the negotiated wage rate is expected to be much lower in 2020 and 2021, and the wage drift should also come out negative (fewer bonuses, etc.), leading to weaker growth in actual wages. Weak inflation, estimated at 1.3% in 2020 and 1.5% in 2021, should nevertheless boost household purchasing power and private-sector consumption. That said, the decline in payroll jobs will drag on disposable income and cause consumption to slide by an estimated 1.4% in 2020 and 1.3% in 2021, versus 1.6% in 2019.

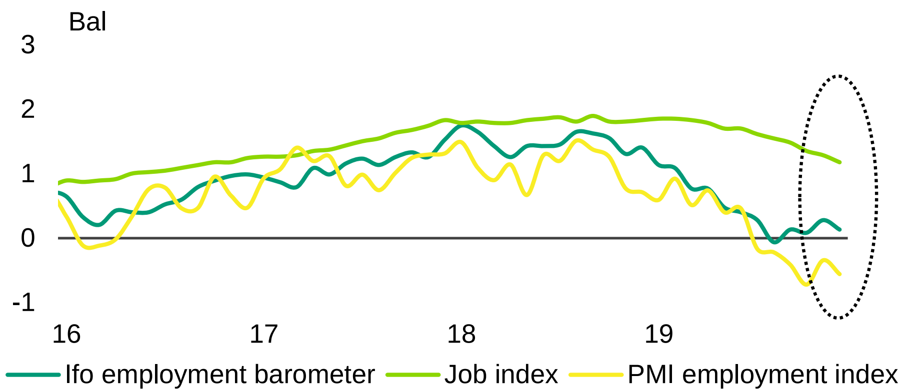
3 BASIS OF OUR SCENARIO
EMPLOYMENT AND WAGE OUTLOOK

Job creations



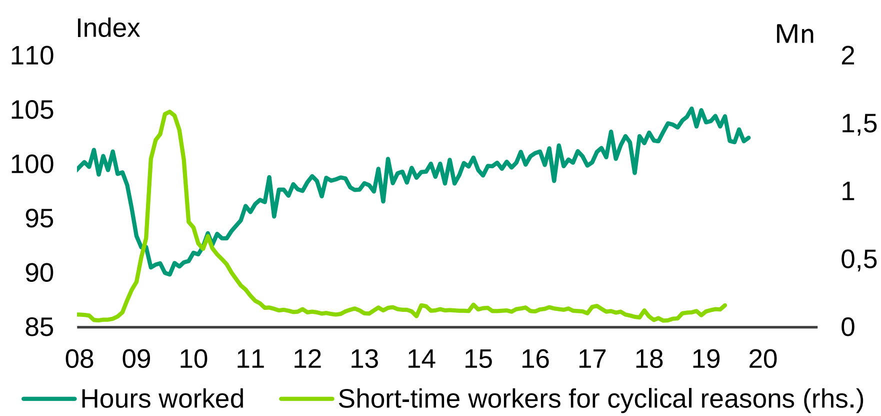
Sources: Bundesbank, Crédit Agricole SA / ECO

Employment indicators



Sources: FSO, Crédit Agricole SA / ECO

Decrease in the number of hours worked

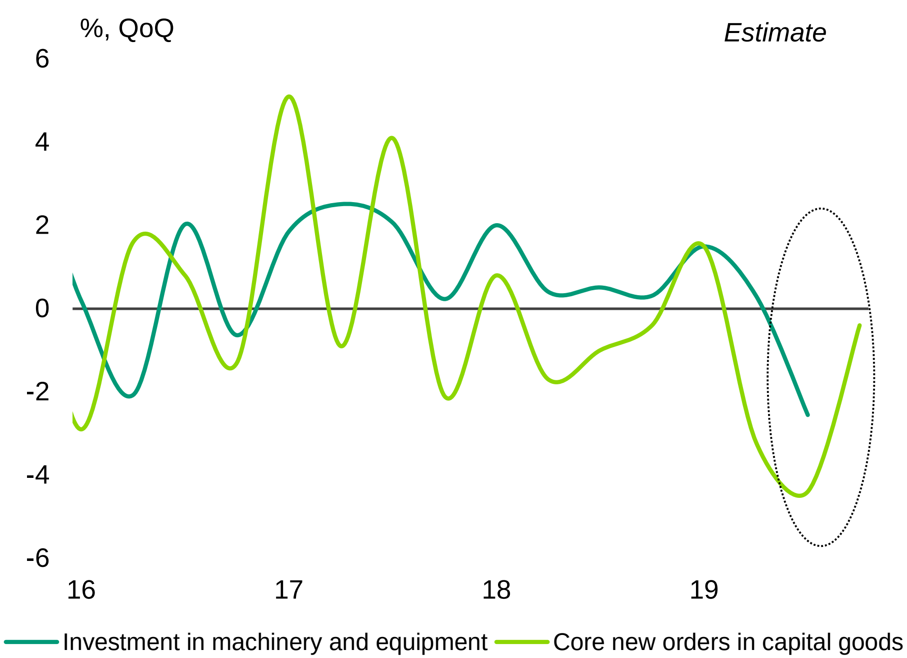


Sources: Agentur für Arbeit, Eurostat, Crédit Agricole S.A

Payroll jobs increased half as fast as October 2018 (+0.7% year-on-year vs. 1.3% a year earlier), tending to return to their long-term average (estimated at +0.6% per year). The unemployment rate (harmonised by Eurostat) is below its equilibrium level (3.5% according to the European Commission) but has stabilised at 3.1% since last May without dropping further. The job vacancy index has continued to decline, with the purchasing managers employment index also deteriorating due to a substantial drop in manufacturing sector hires. The IFO index, however, pointed to a recent improvement in the job situation in November. Even so, all of these surveys argued that payroll jobs were on the decline due to weak manufacturing activity. The smaller number of hours worked, coupled with the drop in temporary jobs and rise in partial unemployment, went hand-in-hand with poor German manufacturing activity.

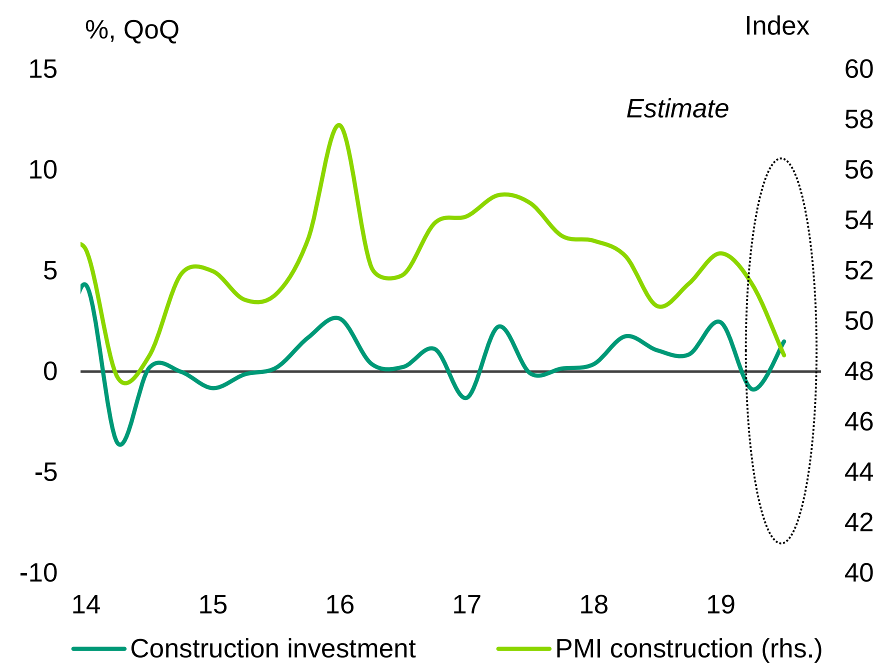
3 BASIS OF OUR SCENARIO
INVESTMENT: SHORT-TERM OUTLOOK

Productive investment



Sources: FSO, Crédit Agricole SA / ECO

Construction



Sources: Markit, FSO, Crédit Agricole SA / ECO.

The improvement in capital goods orders suggested a decline in business investment in Q4 compared to Q3. This relative gain can be attributed to higher foreign orders and more optimistic export prospects for businesses. In terms of construction, the deceleration in manufacturing sector activity was confirmed in Q4, as recorded by monthly PMI surveys. However, investment in construction continued to expand and should help shore up investment growth in Q4 2019, and throughout 2020, thanks to persistently high housing demand, a slowdown in real estate prices after a two-year boom, and as-yet highly favourable lending conditions. Addition factors aiding investment in German construction include stable employment and a sounder financial position.

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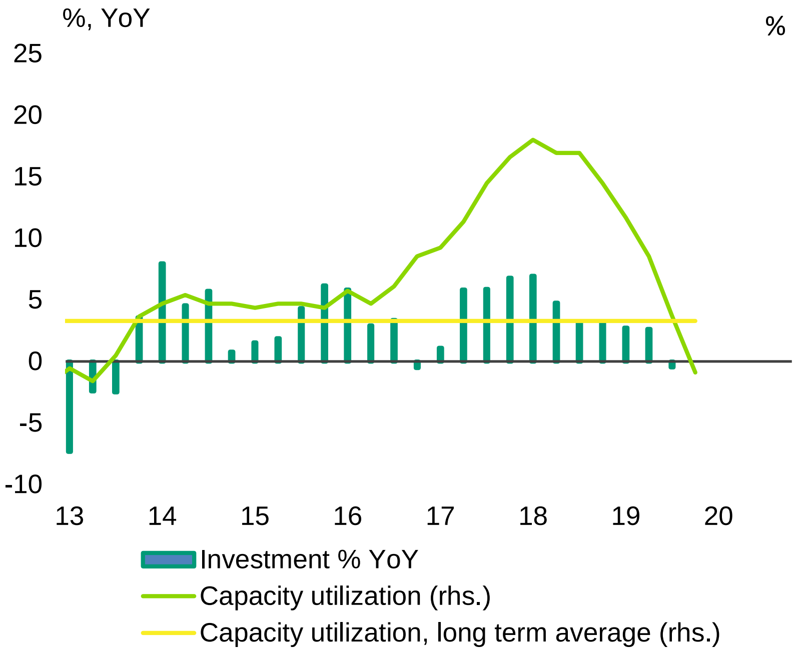
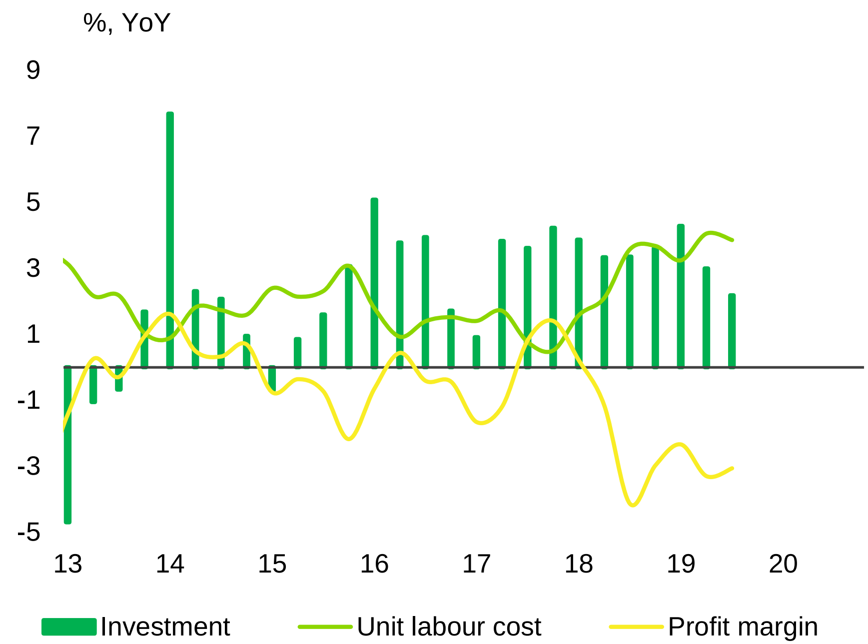
BASIS OF OUR SCENARIO
INVESTMENT: UNDERLYING TRENDS

Productive capacity utilisation rate



Sources: Destatis, Crédit Agricole SA / ECO

Margin ratios, unit wage costs and investment

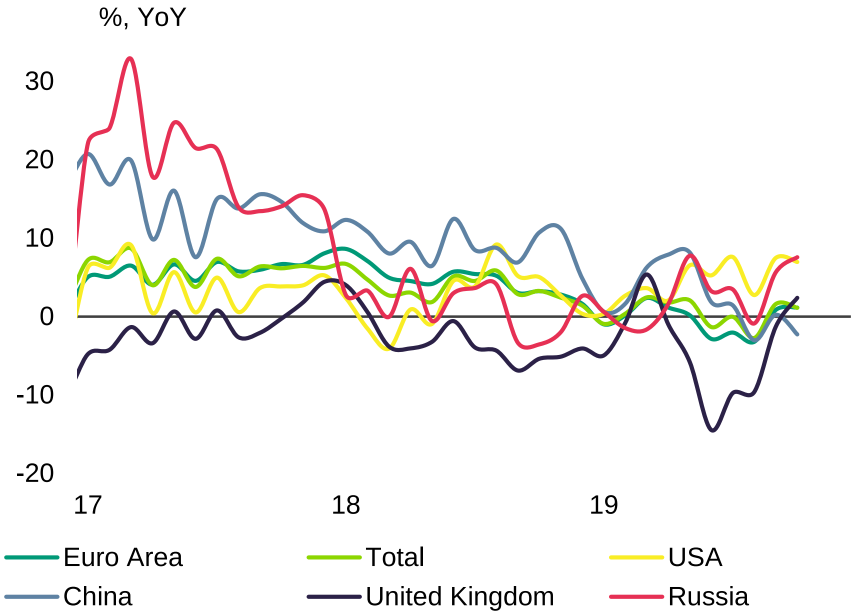


Sources: Destatis, Crédit Agricole SA / ECO

The productive capacity utilisation rate has considerably fallen and is back under its long-term average, a trend that coincided with the manufacturing downturn that began in summer 2018. Growth in unit wage costs flagged in Q3, in line with the slowdown in paid labour. Corporate margins fell even further, due to sluggish demand in export industries spanning several consecutive quarters. We expect investment to continue slowing to +2.7% in 2019 (vs. +3.5% in 2018) and +1.1% on 2020, attributable to sustainably under-potential industrial output prospects.

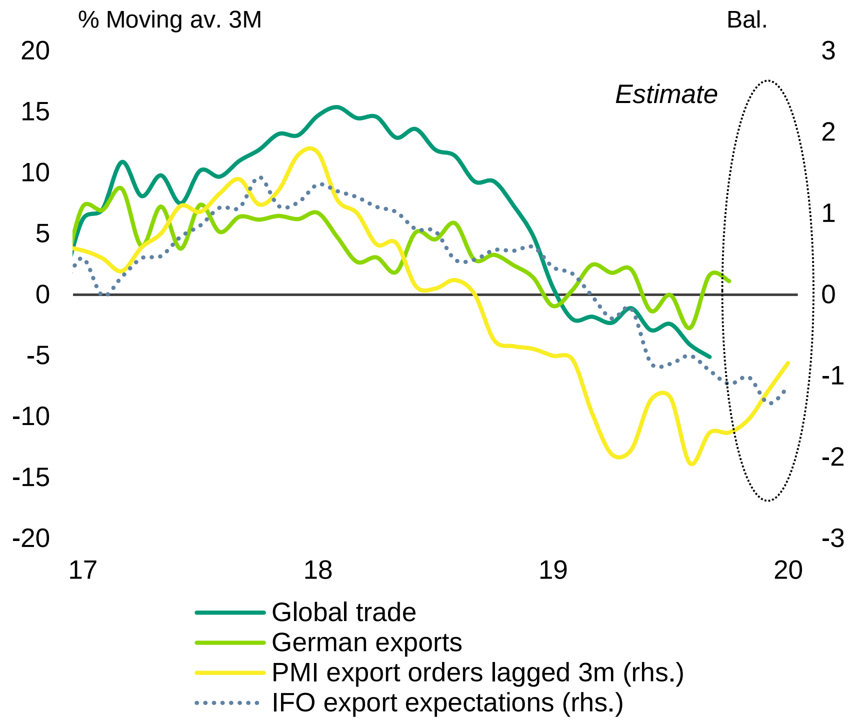
3 BASIS OF OUR SCENARIO
FOREIGN TRADE

Exports by main trading partners



Sources: Bundesbank, Crédit Agricole SA / ECO

Export outlook



Export growth waned through mid-2019, then rebounded as exports to the UK and Russia picked up again, also aided by persistently strong US exports. Conversely, exports to China dropped year-on-year due to the country's economic downturn. Imports increased less than exports, leading to an overall increase in net exports.

The PMI covering export orders suggests that exports rebounded in Q4 and the IFO index recorded the same short-term uptrend. That said, we expect net exports to make another negative contribution to growth of 0.5 GDP pt in 2019 considering the rise in imports over the period. For 2020, an improved export outlook should see net exports making a less negative contribution of 0.3 GDP pt.

Matrix of risks associated with our scenario

		Probability	Impact
↓	Extension of the period of industrial recession	High	High
	Deterioration of the trade balance following an external shock (increase in US tariffs)	High	High
	Euro appreciating against the dollar	Medium	Medium
↑	Accelerating investment	Low	Medium

Source: Crédit Agricole SA / ECO

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1 OVERVIEW

2 RECENT ECONOMIC TRENDS

3 BASIS OF OUR SCENARIO

4 FOCUS: AUTOMOTIVE INDUSTRY CRISIS & SECTOR RELATIONS BETWEEN COUNTRIES

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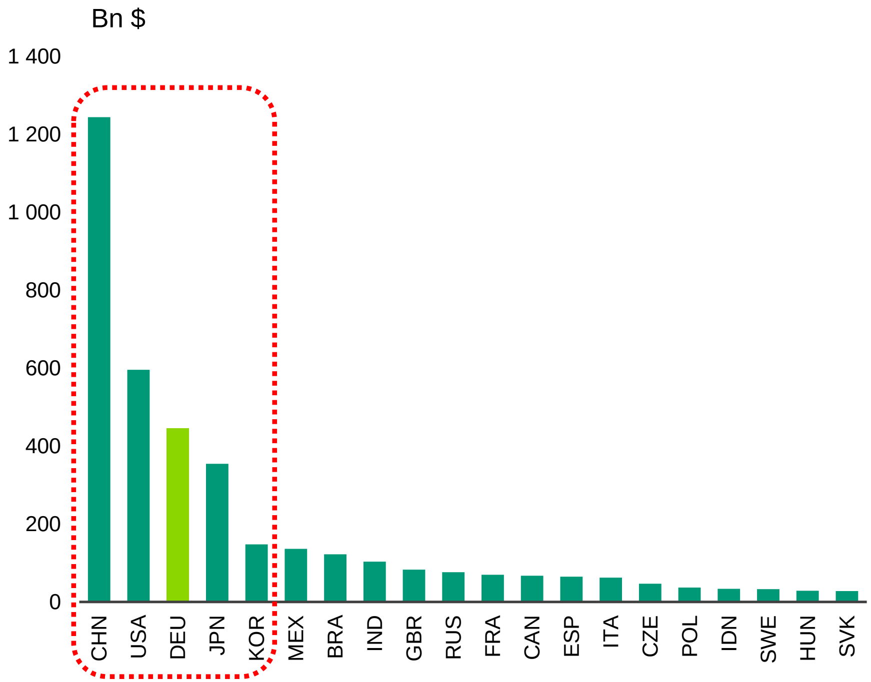
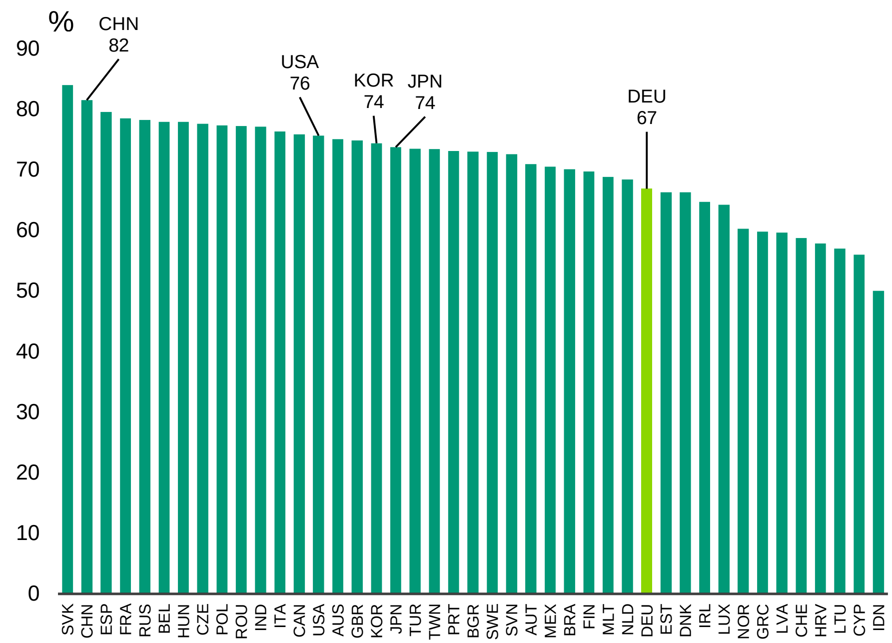
Major Automobile Manufacturers



Sources: WIOD, Crédit Agricole S.A.

Share of intermediate consumption in automobile production

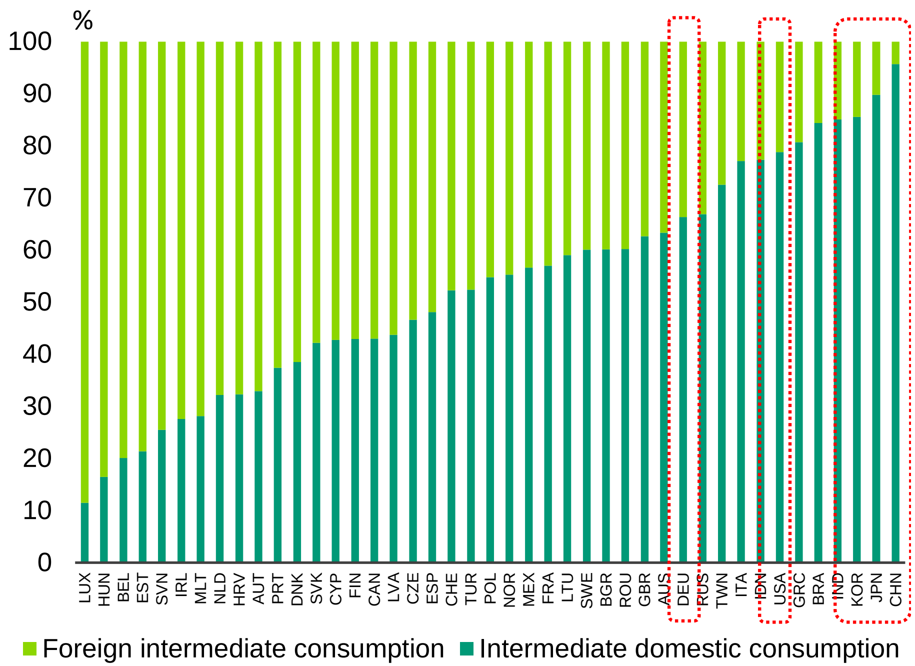


Sources: WIOD, Crédit Agricole S.A.

Germany is a major player in global automotive production ($500bn), ranked No. 3 behind the US and China. As one of the leading manufacturing countries, Germany sets itself apart from its competitors by significantly cutting down on intermediate consumption in the production process, leaving more room for added value. Representing 82% of production in China, 76% in the US and 74% in Japan, intermediate consumption stands at just 67% in Germany. Conversely, added value makes up just 18% in China, 23% in the US, 25% in Japan, yet almost 32% in Germany. Germany owes the success of its automotive sector in part to the high percentage of added value versus its competitors.

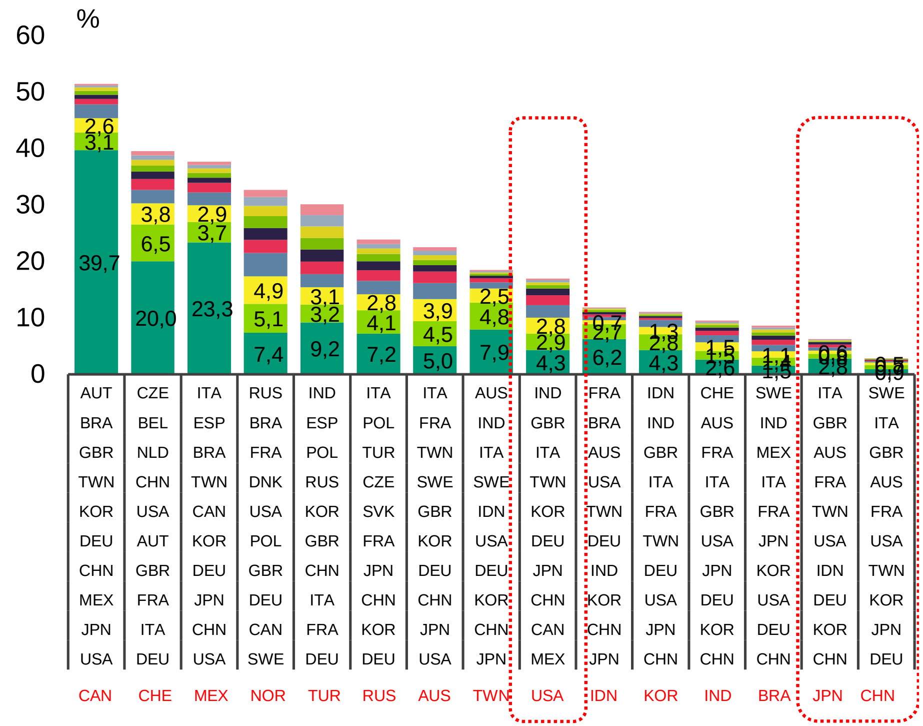
4 FOCUS: AUTOMOTIVE INDUSTRY CRISIS & SECTOR RELATIONS BETWEEN COUNTRIES

Share of foreign intermediate consumption in automobile production



Sources: WIOD, Crédit Agricole S.A.

Main contributors to foreign intermediate consumption in the automotive sector

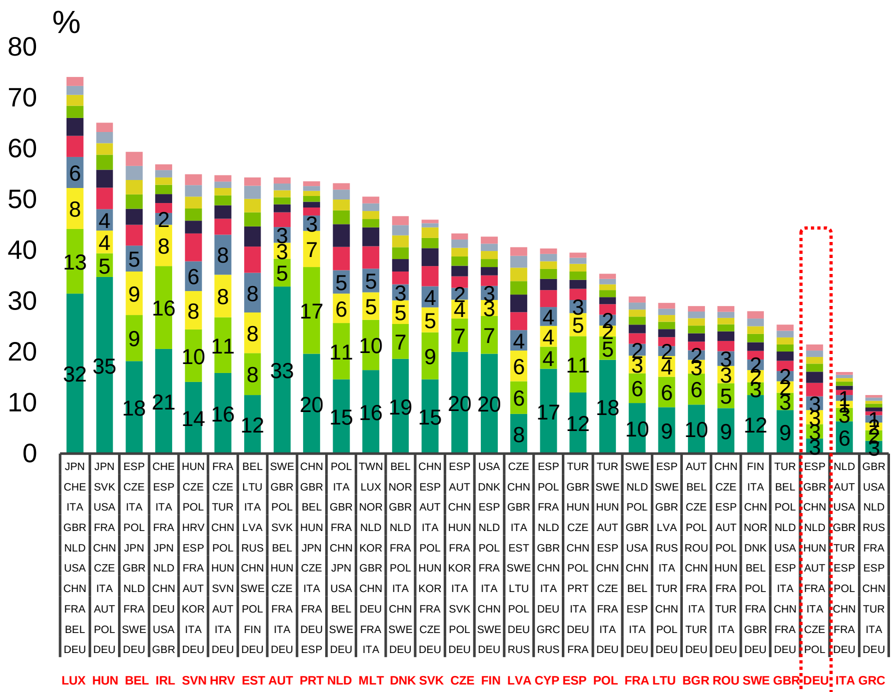


Sources: WIOD, Crédit Agricole S.A.

While the sector uses less intermediate consumption, in Germany it makes up a smaller percentage nationwide compared to its partners. Domestic intermediate consumption stands at 66%, versus 33% from outside Germany. In the US, domestic intermediate consumption sits at 78% and exceeds 95% in China, reflecting the determination of both countries to limit their foreign dependence when it comes to industrial output. By analysing the main contributors to foreign intermediate consumption in the automotive industry, we see that Germany is everywhere around the world, taking first place in China, third in Japan and fifth in the US.

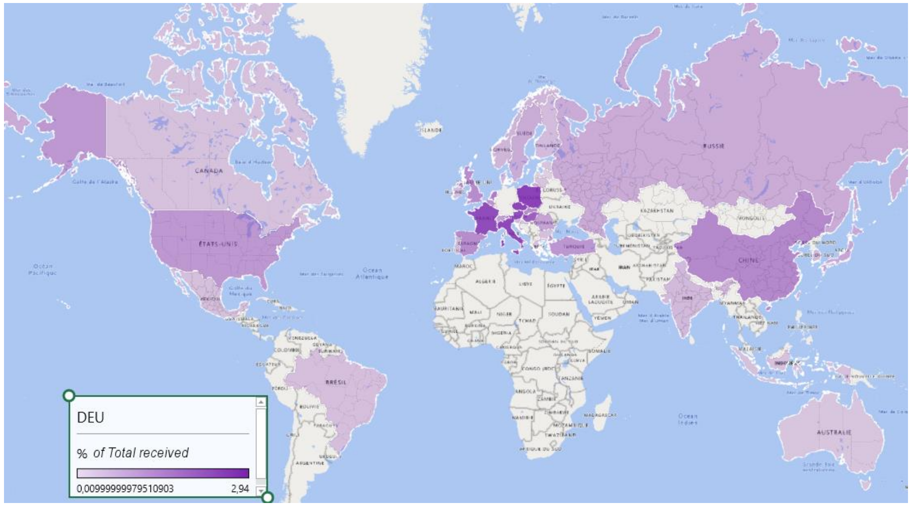
4 FOCUS: AUTOMOTIVE INDUSTRY CRISIS & SECTOR RELATIONS BETWEEN COUNTRIES

Main contributors to intermediate consumption in the European automotive industry



Sources: WIOD, Crédit Agricole S.A.

Mapping of suppliers of intermediate consumption in the German automotive sector



Sources: WIOD, Crédit Agricole S.A.

Germany is understandably a preferred automotive sector supplier in Europe, where it stands firmly as the leading supplier in virtually all countries. It obtains its own suppliers from its European neighbours, in similar proportions between partners. However, Eastern Europe countries, Poland, the Czech Republic, Austria and Hungary are particularly well-positioned in the supply chain. Most of these countries are backstop countries for the German automotive industry due to their lower production costs and geographic proximity. Core European countries such as France and Italy also hold a central place in this system.

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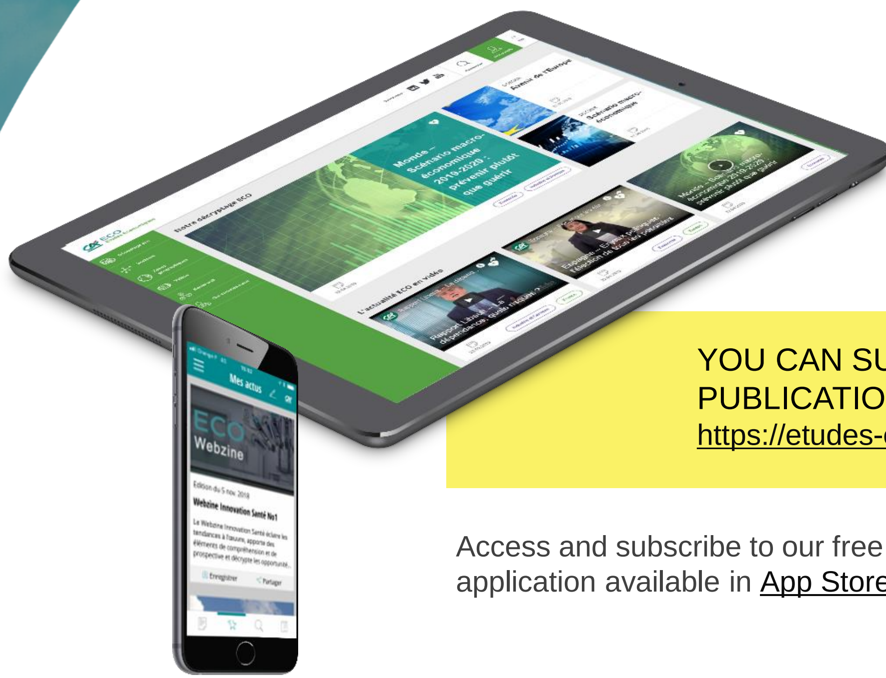

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